RECEIVED

OCT 22 1998

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

AT&T

Joel E. Lubin
Regulatory Vice President
Government Affairs

Room 5460C2
295 North Maple Avenue
Basking Ridge, NJ 07920
908 221-7319
FAX 908 221-4628

EX PARTE OR LATE FILED

Friday, October 22, 1998

Magalie Roman Salas, Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, D.C. 20554

Re: Ex parte - CC Docket No. 96-262, Access Reform

Dear Ms. Salas:

On October 21, I met with William Rogerson, Chief Economist for the Federal Communications Commission to discuss our positions of record in the above-referenced docket. In addition, I reviewed the attached paper entitled, "On Reforming the Regulation of Access Pricing," by Janusz A. Ordover and Robert D. Willig.

Two copies of this Notice are being submitted to the Secretary of the Commission in accordance with Section 1.1206(a)(2) of the Commission's rules.

Very truly yours,

Joel E. Lubin /Am

cc: Mr. W. Rogerson

No. of Copies rec'd 0+2
List ABCDE

Recycled Paper

On Reforming the Regulation of Access Pricing
Salient Points

Schmallensee and Taylor (ST) propose relaxing price regulation on carrier access services as those services become increasingly competitively supplied. They propose that special, dedicated access is ready now for deregulation.

ST proposal is superficially attractive: regulation gets out of the way to permit pricing to adjust to changing market conditions. But, story is up-side-down for today's uniquely distorted access market. Rather than foster a rebalancing of access rates that would occur with deregulation, public policy ought to foster general price decreases in order to enhance economic efficiency. ST's proposed reforms would eliminate any ILEC's incentives to lower the prices that apply to the vast majority of customers, rather than facilitate widespread improvements in pricing. Policy objective should be to promote competition in access and local services and to promote across-the-board, major reductions in access rates to economic costs.

ST's fundamental flaws are unstated assumption that access rates are already aligned overall with the efficient level of costs and assumption that provision of significant portions of access is already highly competitive or soon will be. They argue that the Act eliminated legal barriers to entry and that UNE-based and resale competition already provide potent constraint on market power in the provision of access. Reality is different: for most telecommunications consumers, access rates are substantially higher than forward-looking, economic costs, and competition is limited to pockets of business customers in limited geographic areas.

It is too early to predict speedy emergence of UNE-based entry, and even then success not assured. ST do not and cannot show that all customers enjoy fully effective competition in special and dedicated access. When some customers are unprotected, deregulation would harm them, while helping others. ST do not consider that ILECs are free permanently to lower prices to all customers of special and dedicated access; if competition were pervasive and ILEC prices were too high for competitive success, the ILEC should be able profitably to lower prices to all. Also, access is not a market in which customer-by-customer pricing flexibility increases welfare, because prices are significantly above cost; welfare would be enhanced by reducing prices to all, rather than to a small subset.

ILEC pricing flexibility in access markets can be used to thwart entry and stymie growth in competition. The FCC's "market-based" approach to reducing access prices depends upon UNE-based entry, as well as incentives to broadly lower prices, to do its job. Granting ILEC pricing flexibility would counteract the "market-based" approach by not allowing competition to develop broadly and give no incentives to lower prices broadly. The ILEC monopoly over switched access may only be broken if incentives exist for competition to develop in special access as a springboard to the remainder of the market.

In the end, the ST argument comes down to a simple proposition: Targeted price cuts to selected customers are more profitable than broad-based price reductions. If price deregulation occurred in a narrow geographic slice of the market, then narrowly targeted price decreases might displace broader decreases that would otherwise have been offered. This is not good public policy for the access market.

On Reforming the Regulation of Access Pricing

Janusz A. Ordover and Robert D. Willig

May 11, 1998

In this paper, we offer comments on the public policy prescriptions for the reform of pricing of interstate access pricing offered by Richard Schmalensee and William Taylor in their paper, "The Need for Carrier Access Pricing Flexibility in Light of Recent Marketplace Developments: A Primer."[1] Our key conclusion is that the Schmalensee and Taylor ("ST") proposal for ILEC pricing flexibility in the provision of access does not follow from economic logic applied to the unusually distorted structure of today's interstate access prices. Further, the triggers that ST propose for reducing regulatory oversight and for streamlining regulation of access are inadequate. Hence, the ST policy prescriptions are unlikely to further the pro-competitive objectives of bringing access prices in line with cost, removing the substantial current inefficiencies in the provision of access, and facilitating efficient competition in the provision of local exchange services, including interstate access. Under the ST proposals, ILECs would be able to undermine the growth of competition in the provision of local access, stymie broad-based transition to cost-based pricing of access services mandated by the FCC's Access Reform Docket[2], further weaken the efficacy of the "market-based" approach to regulating local access, and, for the majority of telecommunications customers, delay the benefits from the pro-

---

1 *Ex parte* letter from Mary McDermott, Vice President - Legal & Regulatory Affairs, United States Telephone Association, to Magalie Roman Salas, Secretary, Federal Communications Commission, transmitting the paper "The Need for Carrier Access Pricing Flexibility in Light of Recent Marketplace Developments: A Primer," by Richard Schmalensee and William Taylor, January 20, 1998 ("ST Paper").

2 *See In the Matter of Access Charge Reform,* (inter alia), CC Docket No. 96-262, (*inter*

competitive public policy objectives embodied in the Telecommunications Act of 1996 and the Commission's *Local Interconnection Order* (CC Docket 96-98).

It is critical to begin the discussion of the reasons for our conclusions by pointing out the fundamental disjunction between the economic model of access articulated in the ST paper and the current reality of the market for interstate access services. The ST paper is a superficially attractive articulation of an argument made during the past twenty-five years or so of movement towards regulatory reform in myriad markets (including, at one time, long-distance telephone services: that regulation should get out of the way of adjustments in prices in order to permit market responses to competition and to changing demands. The usual context for this policy recommendation is a market, unlike that for local access, in which prices have been held by regulation in alignment with overall costs, in which new demand and competitive supply circumstances might warrant some readjustments in the relative levels of these prices, and in which the extant regulatory mechanisms impede timely and efficiency-enhancing rate rebalancing that the regulated firm wishes to implement.

It is ironic that while the ST paper retells this attractive economic story as if it applied to today's access services (as it has applied to many other markets over the years), the story is, in fact, up-side-down in the uniquely distorted market for access services: rather than having been aligned with costs either element-by-element or overall, access prices have greatly exceeded those necessary to recover the costs of the provision of access. Rather than requiring mere rebalancing to enhance economic efficiency, access prices generally must decrease significantly

alia), First Report and Order, released May 16, 1997, ¶¶ 258-284.

in order to enhance economic efficiency. Rather than merely impeding rapid adjustments in access prices, historical FCC regulation has generally maintained access prices substantially above pertinent costs. And, rather than reforming extant regulation to reduce access prices to costs, the FCC recently embraced "market-based regulation," whereby it relies on competition to drive access prices down. To complete the irony, today and for the immediate future, the only vigorous competition for the provision of interstate access and local exchange services is confined to a very narrow slice of the market associated with large business telecommunications customers.

Consequently, the conclusions advocated by the ST paper are just as up-side-down for the access services market as are their familiar, but here inapposite, assumptions. In the real access services market, the price movements needed to enhance economic efficiency require regulatory reforms that would tighten -- rather than loosen -- constraints on prices. In the real access services market, the reforms advocated by ST would essentially eliminate any ILEC's incentives to lower the prices that apply to the vast majority of customers, rather than facilitate widespread improvements in pricing. And, in the real access services market, the ST proposals would undermine the anticipated growth in competition rather than promote the benefits of true competition through regulatory reforms. Thus, despite their superficial attraction, ST's arguments and recommendations are up-side-down for today's access service and should be shelved until market events or FCC policy changes make them conform to reality.

The fundamental flaw underlying the ST analysis and policy prescriptions is their unstated assumption that access rates are already aligned overall with the efficient level of costs of providing access[3], and that provision of significant portions of access is already highly competitive, or will become so in the near future. Were such assumptions true, it might follow that access rates should be determined to the maximal extent possible by market forces, and that the Commission should concomitantly forbear from imposing the ~~a~~ heavy hand of regulation lest it distort market entry signals and impose substantial costs on incumbents and consumers. Market realities are, however, significantly different: for most telecommunications consumers (in particular, households and small businesses), access rates are substantially higher than forward-looking economic costs, and competition in the provision of access is limited to pockets of business customers in limited geographic areas. As a consequence, marketplace realities require a different regulatory posture than the one advocated by ST. In today's real access marketplace, the primary objective of regulatory policy should be to foster competition in the provision of access, along with local exchange services, and to promote across-the-board, major reductions in access rates to the level of economic costs.

We agree with ST that "competitive market forces are vastly superior to regulation in the determination of efficient levels of output, investment and price. Thus, where it can safely rely on market forces, the Commission should do so." (ST Paper at 4.) However, effective~~ly~~ competitive market forces in the provision of local access and exchange services are not widely available today, and access pricing flexibility on selective sales is not warranted in the current market environment.

1. Competitive conditions in the provision of access do not warrant the sort of

[3] ST even state that access is below cost in certain geographical areas (ST Paper at 13).

deregulation recommended by Schmalensee and Taylor.

ST argue that, in many respects, the "access market" is highly competitive and ripe for significant deregulation. They base their opinion on two arguments: first, that the 1996 Act lifted all the legal barriers to entry into the provision of local exchange services (including access) and also significantly reduced economic barriers to entry by mandating that the ILECs sell unbundled network elements ("UNEs") at cost-based prices and wholesale their retail services at a discount to competitors, and that certain figures demonstrate that UNE-based competition and resale of local exchange services are not only growing, but are already providing a potent constraint on the ability of the ILECs to exercise market power in the provision of access.[4]

As noted earlier, these arguments do not reflect marketplace realities. Although ST's figures may seem impressive, the fact remains that UNE-based competition is off to a very slow start; each RBOC and the other ILECs still have a virtual monopoly on the general provision of local exchange services -- including access -- and their monopolies are being eroded much more slowly than anticipated. This is due, in part, to the ILECs' delaying tactics, as the Commission (supported by the Department of Justice) repeatedly recognized in its denials of RBOCs' 271 applications for the provision of long distance services.[5] Both the Commission and the

---

[4] Resale does not constrain access pricing because a reseller does not "own" the customer and is thus not entitled to access revenues generated by the customer. At most, resale can provide a reseller with a launch pad into future UNE- and facilities-based competition. These hoped-for forms of competition remain problematic.

[5] *See In the Matter of Southwestern Bell Corporation Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide In-Region, InterLATA Services In Oklahoma,* CC Docket No. 97-121, Memorandum Opinion and Order, released June 26, 1997, and similar proceedings for Ameritech, Michigan, CC Docket No. 97-137, released August 19, 1997, BellSouth, South Carolina, CC Docket No. 97-208, released December 24, 1997 and

Department of Justice concluded that there is currently insufficient competition in the provision of local exchange services, and that mere possibility of future resale-based and UNE-based competition does not provide a constraint on market power adequate to warrant the removal of the long-distance restriction.

BellSouth, Louisiana, CC Docket 97-231, released February 4, 1998.

ST disagree, and argue that "[t]he main effect of the interconnection agreements with UNEs at cost-based rates is to reduce barriers to entry into the local exchange and exchange markets so that most ILEC customers become potential CLEC customers. [M]ost ILEC customers are vulnerable to competitors. Thus, these markets have been fully opened to competition ." (ST Paper at 26.) In our view, it is too early reliably to predict a speedy emergence of UNE-based entry, and even if such significant competition were to start, its success would not be assured.[6] Consequently, we conclude that the currently speculative possibility of future competition in the provision of access does not support arguments for enhanced pricing flexibility for interstate access services.

ST are on more solid ground when they assert that, in many large cities, CAPs and other access providers have made serious inroads into the provision of special and dedicated access. The public policy question is whether this warrants a complete and immediate deregulation of special and dedicated access, as ST argue. (ST Paper at 33.) We think it does not.

First, ST do not and cannot show that all customers enjoy fully effective competition in the provision of special and dedicated access. When some customers are unprotected from the exercise of monopoly power over access, deregulation would harm them, while possibly

---

6 *See* Affidavits of William J. Baumol, Janusz A. Ordover, and Robert D. Willig filed with AT&T's Comments, January 29, 1997, and Reply Comments, February 14, 1997, in response to the December 24, 1996 Notice of Proposed Rulemaking in CC Docket 96-262, *Access Charge*

benefitting others.[7] Hence, it does not follow that public policy should ignore the possible harms to unprotected customers simply because at some future date, competition may more fully constrain the ILECs over a broader set of customers in the provision of these types of access.

Second, ST do not consider the fact that ILECs are free permanently to lower their prices to all customers who demand special and dedicated access. ST focus instead on the alleged competitive harms from regulation-imposed rigidity of prices that the ILECs can charge to individual customers while charging higher price to all others. If competition were pervasive and ILEC prices too high for competitive success, then the ILEC should be able profitably to lower its prices to all consumers.

Third, while there are many circumstances in which customer-by-customer pricing flexibility facilitates competition and customer welfare, the access market is not one of them. Since the access market is characterized by seriously distorted elevations of prices over costs, the main objective of regulation ought to be to reduce prices to all customers rather than to a small subset of individual customers.

Reform.

[7] *See* B. Douglas Bernheim, " An Analysis of the FCC's Proposal for Streamlined Regulation of LEC Access Services," filed as Appendix A to AT&T's submission in CC Docket 94-1, December 5, 1995, for an extensive analysis of the balancing of competitive costs and benefits.

2. Denying ILECs unrestrained pricing flexibility is pro-competition, not pro-competitor.

ST argue that "undue constraints on ILEC's pricing lead to losses in economic efficiency because incorrect market signals are provided to participants. [I]ncorrect market signals can lead to inefficient investments in the telecommunications network: e.g., when a customer decides to purchase from a competitor whose incremental cost is higher than the ILEC's but who, nevertheless, can charge a lower price because the ILEC is prevented from responding by tariff constraints." (ST Paper at 5.) We agree with ST that undue tariff rigidity can lead to distorted investments for the purpose of by-pass and induce wrong customer choices. Nonetheless, unrestricted ILEC pricing flexibility in access markets can be used to thwart entry and stymie the growth of competition in the provision of local access and other local exchange services, while ~~it~~ denying the broad access market the benefits of across-the-board reductions in prices towards costs.

Under the FCC's "market-based" approach to regulation of access, the ILECs are permitted to maintain access prices substantially above costs, but an entrant that wins a local exchange customer need not pay the ILEC excessively for the supply of access to the customer[8]. With this approach, there are two alternatives for access prices generally to be reduced to costs. The first alternative is for competition against ILECs' provision of local exchange and access to develop broadly, so that the preponderance of customers can switch away from the ILECs and thereby avoid the excessive access charges. The second alternative is for the ILECs to lower their access prices substantially across the board in order to stem the flow of lost local customers.

[8] This does not apply to customers of resellers of local exchange services.

Plausibly, alternative routes to generally lower access prices will eventuate because competitive alternatives to ILECs' provision of local exchange and access services may not emerge on a broad scale. Accordingly, only tighter regulation of access prices will decrease them closer to costs, in effect forcing the FCC to reduce its reliance on the "market-based" approach to promoting lower access prices.

If, however, the FCC continues to rely on its "market-based" approach, adopting ST's proposed pricing flexibility would seriously undermine the two alternatives for the general level of access prices to be reduced down to costs. First, under the ST rules, the ILECs would be motivated to employ selective, targeted deep discounts on access services subject to active competitive threat, thereby discouraging possible competitors from investing the sunk costs needed to make the attempt. Thus, even narrowly focused competition would be thwarted, and any hopes that such competition would widen would be dashed. Second, without any prospects for broad-based competition to develop, the ILECs would have no incentive to offer broad-based reductions in access prices. The only customers who would be offered substantial cuts in access prices would be those few that happened to be the beneficiaries of the narrow episodes of competition that survived the deterrant impacts of ILEC pricing flexibility.

Of course, new entry is not a goal in itself. Inefficient entry wastes social resources and may lead to higher future costs. However, because the FCC has chosen the "market-based" approach to regulating access rates, it is essential for the success of this policy that competition in markets for all types of access services for all types of consumers take hold and then develop quickly and fully in a manner that benefits overall consumer welfare.

ST wrongly dismiss this argument by equating it with "infant industry" rationales for protection. However, this is not the case in the current, unusual circumstances that exist in the access market. There are significant positive externalities from competition in the provision of special and dedicated access to competition in the provision of switched access. The ILECs still hold a virtual monopoly on switched access. This monopoly may be eroded, in part, by vendors that extend their special, dedicated access services to switched access. Consequently, sound public policy reasons exist to provide incentives for firms to enter into the provision of special and dedicated access, and increase their market share there as a springboard for entry into more entrenched areas of ILECs' access monopoly, such as switched access. Contrary to ST's arguments, it is irrelevant that the potential entrants are "well financed" companies such as AT&T or MCI; even well-financed companies are unlikely to enter a market and provide a service if they do not expect to earn a normal rate of return on their investments. The ILECs' market position in the provision of access services is difficult to dislodge because of their incumbency advantages, because of sunk costs and other risks associated with entry into the provision of access, and because of the difficulties in obtaining UNEs and OSS on cost-based terms. In fact, as ST show, with the sole exception of special and dedicated access, the entrants have not been able to divert any significant share from the ILECs to any significant extent. Moreover, the widely touted investment projects in local exchange infrastructure have yet to be implemented. Hence, currently, given the FCC's "market-based" approach to access price regulation, the use of special and dedicated access services as a possible springboard for further growth of competition is a socially desirable means of whittling away at the ILECs' market dominance in the provision of access.

Echoing familiar arguments against "asymmetric regulation," ST complain that ILECs, unlike the CAPs and other vendors, are denied pricing flexibility, thereby placing them at a competitive disadvantage. ST ignore the fact that ILECs have many competitive advantages in the provision of access and other local exchange services. There is no evidence, and ST adduce none, that any competitive losses by ILECs in the provision of special and dedicated access have created financial difficulties that make them less well-positioned for future competition in the provision of various telecommunications services. To the contrary, the available evidence indicates that the margins on access services are very high, approximately $8 - 9 billion per year nationwide[9], and that there is no justification for an express subsidy to large LECs before competition has developed in their local exchange marketplace.[10] Hence, the ILECS' revenue losses do not jeopardize their ability to meet their current regulatory obligations. Finally, and most important, ILECs are free to respond to price offerings made by their rivals. In particular, ILECs can readily meet competitive offerings with across-the-board price cuts, which would benefit telecommunications consumers and be consistent with the FCC's policy goals expressed in its *Access NPRM.* ST and cannot argue that such broad-based cuts would lower prices below the forward-looking economic costs of providing access. Because access is priced significantly above cost, substantial leeway for price reductions still exists. In the end, the ST argument comes down to a simple proposition: "targeted price cuts to selected customers are more profitable than broad-based price reductions." We agree, but find that this does not create a public interest rationale for greatly easing regulatory constraints on the ILECs. In sum, while

---

9 *See* letter from Mark Rosenblum, Vice President, Law and Public Policy, AT&T, to William E. Kennard, Chairman, Federal Communications Commission, March 5, 1998, at page 6.

10 *See En Banc Presentation of Joel Lubin,* Docket 96-45, March 6, 1998.

the ILECs are regulated differently from the CAPs and CLECs, this fact is not likely to engender the kind of social losses and inefficiencies that ST cite from other industries, due to the dramatically different circumstances unique to this industry today.

3. The ST triggers for pricing flexibility are insufficient for streamlined regulation.

We agree that "clear and objective triggers that are easily measured and verified can reduce contention and allow regulators to expedite proceedings to provide additional pricing flexibility . . . ." (ST Paper at 32.) Our concern is that ST's proposed triggers are both insufficiently precise and too lax. ST's arguments seem to rely heavily on their belief in the absence of legal entry barriers and the power of potential competition as an effective constraint on the ILECs' ability to exercise market power. Given the present state of the marketplace, we lack confidence in the constraining power of potential competition and the adequacy of triggers that rely on potential competition to streamline regulation. In the local telecommunications markets of today, substantially more stringent triggers must be adopted if they are to serve as the sole regulatory tool. Although market-share based triggers may be satisfied on a geographically disaggregated basis (as in downtown areas of major cities), other regulatory tools and constraints would have to accompany these triggers in order to accomplish the Commission's stated goals of lowering access prices to all areas. If price deregulation occurred only within a narrow geographical area because metrics of competition were observed only there, then narrowly targeted price decreases might displace broader decreases that would otherwise have been offered. The end of price uniformity would also require that an accompanying constraint that would offer protection against the LECs' ability to leverage its monopoly power from other access components and unbundled network elements.[11] However, even this might not be sufficient to achieve the Commission's goal of lowering access prices to all consumers. Regulatory relief for the pricing of special access and dedicated transport under the FCC's regime of "market-based" access regulation would still not promote -- and, indeed, would likely undermine -- needed progress towards generally lower prices for access components or services of any sort. Adoption of ST's proposals would, therefore, not represent good public policy at this time.

In sum, based on both the facts and economic analysis, we disagree with ST's claim that there is currently a public interest rationale to grant the ILECs added pricing flexibility in the provision of access services.

[11] *See, e.g.*, the family of price caps (or, more accurately, revenue caps) for all the LECs' access components and the services that use these access components offered in the Bernheim Affidavit referenced in fn 6, *supra.*